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No. 03-776

Supreme Court, U.S.
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In The Supreme Court of the United States

FRANCHISE TAX BOARD,

Petitioner,

v.

FARMER BROS. CO.,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The Second Appellate District

OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, Farmer Bros. Co. states that it is a publicly held California corporation. Farmer Bros. Co. does not have a parent corporation and there are no publicly held companies owning 10% or more of Farmer Bros. Co.'s stock.

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PRELIMINARY MATTERS

Respondent, Farmer Bros. Co. ("Farmer Bros."), accepts the description of Parties to the Proceeding, the Opinions Below, the Basis for Supreme Court Jurisdiction, and the Constitutional and Statutory Provisions Involved as stated by Petitioner, Franchise Tax Board ("FTB"), in its Petition for a Writ of Certiorari ("Petition").

Farmer Bros. supplements the FTB's Statement of the Case in the following section. Farmer Bros. clarifies the Question Presented for Review in its discussion of the Reasons for Denying the Petition, set forth below.

STATEMENT OF THE CASE

Two material features of the ruling by the California Court of Appeal below were neglected by the FTB in its summary.

First, in addition to finding that section 24402 of the California Revenue and Taxation Code facially discriminates against interstate commerce, the Court of Appeal concluded the statute also violates the "internal consistency doctrine" because the adoption of an identical statute by other states would impose a burden of multiple taxation where dividend-paying companies and dividend-receiving companies are located in different states. No such multiple tax burden would be imposed where those companies are located within a single state. (Ct. App. Op., Pet. App. 14-15.)[1]

[1] References to the Appendix to the Petition for a Writ of Certiorari are denominated "Pet. App." followed by a page reference. References to

(Continued on following page)

Second, the Court of Appeal rejected the FTB's claim that the trial court had erroneously excluded expert testimony to support the FTB's position that the compensatory tax defense should save the dividends received deduction from invalidation under the Commerce Clause. The Court of Appeal concluded, "FTB fails to show that it ever proffered or sought to introduce any such testimony, that it made an offer of proof, or that the trial court made any ruling on the matter. In other words, there is simply no ruling for us to review. A party on appeal cannot successfully complain because the trial court failed to do something which it was not asked to do." (*Id.* at 22.)

REASONS FOR DENYING THE PETITION

This case involves the question of whether a state that grants a dividends received deduction ("DRD") can permissibly limit that deduction to dividends paid from income previously taxed by that state. Every court that has considered this question has concluded that such a limited DRD violates the Commerce Clause. The unanimity of judicial authority on this question is not surprising, because it is compelled by this Court's unanimous opinion in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), which struck down a tax regime that was functionally identical to these limited DRDs. For these reasons and for others discussed below, the Petition should be denied.

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the Petition for a Writ of Certiorari are denominated "Pet." followed by a page reference.

A. There Is No Conflict in Judicial Authority over the Proper Resolution of the Question Presented

Two other state courts have considered the constitutionality of limited DRDs that were in all essential respects identical to the limited DRD at issue here, and each court struck down the DRD for the same reasons on which the decision below relied.

D.D.I., Inc. v. State

In *D.D.I., Inc. v. State*, 2003 N.D. 32, 657 N.W.2d 228 (2003), the North Dakota Supreme Court considered a DRD that was in all practical respects identical to the DRD here. In that case, the State Tax Commissioner conceded that the limited DRD "facially discriminate[d] against interstate commerce," *id.* at ¶ 7, 657 N.W.2d at 231, but, like the FTB in this case, the Tax Commissioner argued that the restricted DRD was saved by the compensatory tax defense and should not be treated as discriminatory because its purpose was to prevent double taxation.

The North Dakota Supreme Court rejected that argument, finding that the Tax Commissioner had failed to meet at least two of the three prongs required to establish the compensatory tax defense.[2] First, like the lower court here, the North Dakota Supreme Court found that the State had failed to identify "any specific in-state activity or benefit received by the taxpayers to justify the

[2] To invoke successfully the compensatory tax defense, a state must meet all three prongs of the defense. *See, e.g., Fulton Corp. v. Faulkner*, 516 U.S. 325, 332, 344 (1996); *Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality of Or.*, 511 U.S. 93, 103 (1994).

compensatory levy on their dividends received from out-of-state corporations." *Id.* at ¶ 15, 657 N.W.2d at 234. In doing so, the North Dakota Supreme Court, like the Court of Appeal in this case, rejected the State's attempt to rely upon the income tax imposed upon in-state operating companies as a compensatory twin for the income tax imposed upon companies receiving dividends.[3]

Second, the North Dakota Supreme Court found that when the effects of other state taxes on the dividend-paying company were considered, the State's limited DRD did not result in a tax on interstate commerce that roughly approximates the tax on intrastate commerce. Here the North Dakota court's analysis essentially mirrors the California court's analysis in this case and rests upon the framework developed in this Court's internal consistency cases. *See, e.g., Armco Inc. v. Hardesty*, 467 U.S. 638 (1984); *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Am. Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266 (1987).

Third, because the Tax Commissioner had failed to meet the first two prongs of the compensatory tax defense, the North Dakota Supreme Court concluded it need not address whether the limited DRD satisfied the third prong of the compensatory tax defense, *i.e.*, whether the taxes on intrastate and interstate commerce were imposed upon substantially equivalent events.

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[3] Farmer Bros. concurs with the FTB that under this Court's precedent, the denial of a deduction should be treated as equivalent to the imposition of a tax. (Pet. 14 n.16.)

Finally, in regard to whether the purpose of preventing double taxation ought to save the limited DRD, the North Dakota Supreme Court stated:

> [A]lthough avoiding double taxation of North Dakota income is a legitimate legislative goal, "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." *Oregon Waste*, at 100. We have concluded the method employed by the State of North Dakota impermissibly discriminates against interstate commerce. Taxpayers have asserted and the Commissioner does not dispute there are nondiscriminatory means to accomplish the goal of avoiding double taxation on North Dakota corporate income.

D.D.I., at ¶ 19, 657 N.W.2d at 235.

Ceridian Corp. v. Franchise Tax Bd.

Another district of the same California Court of Appeal that issued the opinion in this case issued an earlier decision involving a limited DRD that was applicable to dividends paid by insurance companies. *Ceridian Corp. v. Franchise Tax Bd.*, 85 Cal. App. 4th 875 (2000). Like the limited DRD in this case, this insurance DRD was also restricted to dividends paid from insurance income "from California sources." Apparently for that reason, in *Ceridian* the FTB had characterized the insurance DRD at issue as the "counterpart" to the more general DRD at issue in this case. *Id.* at 884.

In *Ceridian,* as here, the FTB argued that the insurance DRD did not constitute facial discrimination against interstate commerce because its purpose was to avoid double taxation of California income. Nonetheless, as in

this case, the California Court of Appeal concluded the insurance DRD was "unquestionably discriminatory on its face." *Id.* at 887. Finally, the *Ceridian* court found the FTB's concession that the compensatory tax defense was not applicable to the insurance DRD was "well taken" since, in the court's view, the FTB could not have met the three-pronged test required by that defense. *Id.* at 886.

B. The Decision Below Is Compelled by This Court's Decision in *Fulton*

The decision below (and the decisions of other courts that reached the same conclusion) is compelled by this Court's decision in *Fulton*.

In *Fulton*, this Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed. The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory:

> A regime that taxes stock only to the degree that its issuing corporation participates in interstate

> commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Fulton, 516 U.S. at 333.

California's DRD suffers from precisely the same constitutional infirmity. It permits a taxpayer a DRD only to the extent that the dividend-paying corporation does business in California. Thus, just as in North Carolina, the taxpayer receives a benefit only insofar as the corporation in which it has invested is doing business in the taxing state. If the dividend-paying corporation were doing all of its business in California, a taxpayer would be entitled to a 100 percent DRD; if the dividend-paying corporation were doing 50 percent of its business in California, a taxpayer would be entitled to a 50 percent DRD; and if the dividend-paying corporation were doing none of its business in California, no DRD would be allowed. The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

> A regime that [denies a DRD] only to the degree that [the dividend-paying corporation] participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id. Accordingly, California's limited DRD also "facially discriminates against interstate commerce." *Id.*

In *Fulton,* North Carolina maintained that the intangibles tax should nonetheless be sustained because it

satisfied each of the three conditions of the compensatory tax doctrine. *Id.* at 334. For reasons that are controlling here (and on which the court below relied), this Court found that, in fact, none of these three required conditions had been satisfied.

First, the Court observed that where a state identifies an intrastate tax as the basis for a proposed compensatory tax defense, "it should go without saying that this intrastate tax must serve some purpose for which the State may otherwise impose a burden on interstate commerce." *Id.* This requirement defeated North Carolina's attempt to offer its general corporate income tax as a compensatory burden for its intangibles tax because "North Carolina ha[d] no general sovereign interest in taxing income earned out of state." *Id.* California likewise has "no general sovereign interest in taxing income earned out of state," and it therefore cannot justify a tax on dividends paid to California taxpayers by its inability to tax the out-of-state earnings from which those dividends are derived.

Second, the Court found that the State also failed to meet the second prong of the compensatory tax defense that the tax on interstate commerce approximate, but not exceed, the amount of the tax on intrastate commerce. In reaching its decision, the Court observed that "[w]here general forms of taxation are involved, we ordinarily cannot even begin to make the sorts of quantitative assessments that the compensatory tax doctrine requires." *Id.* at 338. The Court of Appeal in this case reached the same conclusion.

Finally, the Court concluded that the State had failed to demonstrate that the two taxes fell upon substantially equivalent events, because the levies fell upon two different

parties. Precisely the same lack of "equivalence" exists here because the two allegedly complementary taxes – the tax on the dividend-paying corporation's income and the tax on the dividend-recipient's income – fall on different taxpayers, namely, the payor and the payee.

Fulton remains sound law. Certainly, all three state courts that have reviewed limited DRDs in the wake of *Fulton* have agreed that the decision effectively governs their results. In light of this conformity and the close match between this case and the issues addressed in *Fulton*, the FTB's Petition offers no compelling reason for the Court's intervention in this litigation. Sup. Ct. R. 10.

THE QUESTIONS POSED BY THE STATE WOULD NEITHER PROVIDE IMPORTANT GUIDANCE NOR CONTROL THE RESULT IN THIS CASE

In light of the fact that there is a unanimous body of judicial authority supporting the decision below, which is dictated by this Court's decision in *Fulton*, the FTB is compelled to rest its Petition on an invitation for this Court to explore two esoteric questions relating to the application of the compensatory tax doctrine, neither of which requires this Court's guidance. The first – "whether the compensatory tax defense has application when a single levy is involved" (Pet. 15) – is not even in dispute. The uniform line of decisions, including that of the Court of Appeal below, rejected the compensatory tax defense on the merits, not because it was purportedly inapplicable to a single levy.

As to the second question on which the FTB seeks this Court's guidance – "whether a tax on a corporation is . . . equivalent to a tax on the dividend income received by

shareholders" (Pet. 16) – the Court effectively resolved the question in *Fulton*, roundly rejecting the State's effort to analogize a tax on a corporation to a tax on its shareholders. Moreover, insofar as the Court acknowledged that the questions might be open as a matter of "principle," *Fulton*, 516 U.S. at 341, the record here provides no stronger basis for such an inquiry than did the record in *Fulton*.

As the Court observed in *Fulton*, the question posed by the FTB involves "complex factual inquiries" that courts "are poorly equipped to evaluate with precision" because the question, at bottom, is whether the economic incidence of a tax should be treated as different than the nominal incidence of that tax. *Id.* at 341-42. The record here is totally bereft of any facts, let alone expert analysis, which would allow a trial court, much less this Court, to even begin such an evaluation. Indeed, the Court of Appeal in this case commented that the FTB had failed altogether to "offer any factual or logical support for its claim that the actual incidences of these two taxes are imposed upon the same class of taxpayers." (Ct. App. Op., Pet. App. 21.)

Moreover, even if the FTB could prevail on this question, it would be of no moment here, because the question goes only to one of the three prongs of the compensatory tax defense. There can be no dispute that California's limited DRD flunked the other two prongs of the test. (Ct. App. Op., Pet. App. 16-20.) One does not pass the compensatory tax test with a grade of 33-⅓ percent.

CONCLUSION

In its Petition, the FTB fails to provide any basis, much less a compelling reason, for granting certiorari. This Court's ruling in *Fulton* compelled the decision reached on the merits below. The California Court of Appeal here, just as each other state court that has considered the constitutionality of a limited DRD, closely adhered to the analysis in *Fulton* and, by striking down the limited DRD as discriminatory against interstate commerce in violation of the Commerce Clause, arrived at the same result. The Petition accordingly should be denied.

Respectfully submitted,

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APPENDIX A

D.D.I., Inc., Danov Corporation, and Estuary Corporation, Florida corporations, Plaintiffs and Appellees v. State of North Dakota, by and through its Tax Commissioner, Rick Clayburgh, Defendant and Appellant

No. 20020241

SUPREME COURT OF NORTH DAKOTA

2003 ND 32; 657 N.W.2d 228; 2003 N.D. LEXIS 39

March 5, 2003, Filed

PRIOR HISTORY: Appeal from the District Court of Burleigh County, South Central Judicial District, the Honorable Robert O. Wefald, Judge.

DISPOSITION: Affirmed.

COUNSEL: William P. Pearce (appeared), Pearce & Durick, Bismarck, N.D., Richard A. Husseini (argued), Geoffrey Schultz (appeared), James Edward Maloney (on brief), Maryanne Lyons (on brief), Baker Botts L.L.P., Houston, TX, Gerard Desrochers (on brief), Houston, TX, for plaintiffs and appellees.

Donnita A. Wald (argued), Special Assistant Attorney General and Robert W. Wirtz (appeared), Special Assistant Attorney General, Tax Department, Bismarck, N.D., for defendant and appellant.

JUDGES: Opinion of the Court by Kapsner, Justice. Carol Ronning Kapsner, Dale V. Sandsrom, William A. Neumann, Mary Muehlen Maring, Gerald W. VandeWalle, C.J.

OPINION BY: Carol Ronning Kapsner

OPINION: Kapsner, Justice.

The State of North Dakota, by and through its Tax Commissioner ("Commissioner"), appealed from a judgment declaring the dividends received deduction in N.D.C.C. § 57-38-01.3(1)(g) unconstitutional and enjoining collection of the Commissioner's assessments of corporate income tax against D.D.I., Inc., Danov Corporation, and Estuary Corporation (collectively referred to as "taxpayers").[1] We hold the dividends received deduction is not a valid compensatory tax and violates the Commerce Clause. We affirm.

I

The taxpayers are Florida corporations engaged in managing assets, including oil and gas properties in North Dakota, and they pay North Dakota corporate income taxes on their net income from business done by them in North Dakota. The taxpayers also receive dividend income from other corporations conducting business either wholly or primarily outside of North Dakota. D.D.I. and Estuary initially excluded the dividends received from those other corporations in the calculation of their North Dakota corporate income tax for tax years 1989 through 1997, and Danov excluded those dividends for tax years 1989 through 1995. The Commissioner determined those dividends were business income subject to apportionment, and to the extent the Commissioner determined the dividends were includable in the taxpayers' North Dakota apportioned income, the Commissioner applied the dividends

[1] The Commissioner has not separately raised or argued the appropriateness of the injunctive relief granted by the district court. We, therefore, do not address the issue.

received deduction under N.D.C.C. § 57-38-01.3(1)(g), which authorizes adjustments to a corporation's taxable income and provides:

> 1. The taxable income of a corporation as computed pursuant to the provisions of the Internal Revenue Code of 1954, as amended, must be:
>
> . . . .
>
> g. Reduced by dividends or income received by any person from stock or interest in any corporation, the income of which has been assessed and paid by a corporation under this chapter or sections 57-35.3-01 through 57-35.3-12, received by the taxpayer and included in the gross income within the income year if such corporation has reported the name and address of each person owning stock and the amount of dividends or income paid each such person during the year, but when only part of the income of any corporation has been assessed and income tax paid under this chapter or sections 57-35.3-01 through 57-35.3-12, only a corresponding part of the dividends or income received therefrom may be deducted.

The taxpayers brought this declaratory judgment action against the Commissioner, claiming the dividends received deduction violated the Commerce Clause. The trial court concluded the dividends received deduction violated the "negative" or "dormant" aspect of the Commerce Clause because the deduction was similar to a North Carolina "intangibles tax" held unconstitutional in *Fulton Corp. v. Faulkner,* 516 U.S. 325, 133 L. Ed. 2d 796, 116 S. Ct. 848 (1996). The Commissioner appealed.

II

The Commerce Clause, U.S. Const. art. I, § 8, cl. 3, grants Congress the power "[t]o regulate commerce . . . among the several States." Although the Commerce Clause is phrased as a grant of power to Congress, it has long been understood to have a "negative" or "dormant" aspect that denies states the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce. *Fulton,* 516 U.S. at 330; *Oregon Waste Sys., Inc. v. Department of Envtl. Quality,* 511 U.S. 93, 98, 128 L. Ed. 2d 13, 114 S. Ct. 1345 (1994). The Commerce Clause grants Congress plenary authority over interstate commerce to avoid the economic balkanization that had plagued relations among the colonies and later among the states under the Articles of Confederation. *Oregon Waste,* 511 U.S. 93 at 98. The "negative" or "dormant" aspect of the Commerce Clause prohibits economic protectionism designed to benefit in-state economic interests by burdening out-of-state competitors. *Fulton,* 516 U.S. 325 at 330.

In *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 288-89, 51 L. Ed. 2d 326, 97 S. Ct. 1076 (1977), the United States Supreme Court rejected a formalistic approach to Commerce Clause challenges to state taxes. *See generally* 1 Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* ¶ 4.11[1] (3rd ed. 2001). The Court recognized that entities engaged in interstate commerce were not immune from state taxation and said "'"it was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business." *Western Live Stock v. Bureau of Revenue,* 303 U.S. 250, 254, 82 L. Ed. 823, 58 S. Ct. 546 (1938).'" *Complete Auto,* 430 U.S. 274 at 288 (quoting *Colonial Pipeline Co. v.*

Traigle, 421 U.S. 100, 108, 44 L. Ed. 2d 1, 95 S. Ct. 1538 (1975)). The Court articulated a four-part test under which a state tax would be sustained against a Commerce Clause challenge if (1) the tax was applied to an activity with a substantial nexus with the taxing state, (2) the tax was fairly apportioned, (3) the tax did not discriminate against interstate commerce, and (4) the tax was fairly related to the services provided by the state. *Complete Auto,* 430 U.S. 274 at 279, 287.

Here, the dispositive issue under that four-part test is whether the dividends received deduction discriminates against interstate commerce. In *Oregon Waste,* 511 U.S. at 99, the Court defined "discrimination" to mean "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *See also Fulton,* 516 U.S. at 331 (quoting *Chemical Waste Mgmt., Inc. v. Hunt,* 504 U.S. 334, 342, 119 L. Ed. 2d 121, 112 S. Ct. 2009 (1992) for principle that statute is discriminatory if it "taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State"). State laws that facially discriminate against interstate commerce are subject to the "strictest scrutiny" and are "virtually *per se* invalid." *Fulton,* at 331, 344; *Oregon Waste,* at 99-101.

The Commissioner concedes the dividends received deduction facially discriminates against interstate commerce. A facially discriminatory tax may survive Commerce Clause scrutiny if the tax is a "compensatory" or "complementary" tax that requires interstate commerce bear a burden already born by intrastate commerce. *Fulton,* 516 U.S. 274 at 331-33. The compensatory or complementary tax doctrine assures that "'[w]hen the account is made up, the stranger from afar is subject to no

greater burdens as a consequence of ownership than the dweller within the gates. The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.'" *Fulton,* 516 U.S. at 332 (quoting *Henneford v. Silas Mason Co.,* 300 U.S. 577, 584, 81 L. Ed. 814, 57 S. Ct. 524 (1937)). In *Fulton,* 516 U.S. 325 at 332-33, the Court enunciated three requirements for a valid compensatory tax:

> First, "a State must, as a threshold matter, 'identify . . . the [intrastate tax] burden for which the State is attempting to compensate.'" *Oregon Waste, supra,* 511 U.S. 93 at 103 (quoting *Maryland v. Louisiana,* 451 U.S. 725, 758, 68 L. Ed. 2d 576, 101 S. Ct. 2114 (1981)). Second, "the tax on interstate commerce must be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce." *Oregon Waste,* 511 U.S., at 103. "Finally, the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other." *Ibid.* (quoting *Armco Inc. v. Hardesty,* 467 U.S. 638 at 643, 81 L. Ed. 2d 540, 104 S. Ct. 2620 (1984)).

The Commissioner argues the dividends received deduction must be presumed constitutional because statutes enjoy a strong presumption of constitutionality in North Dakota, *see MCI Telecomms. v. Heitkamp,* 523 N.W.2d 548, 552 (N.D. 1994), and the taxpayers have failed to prove beyond a reasonable doubt the dividends received deduction is unconstitutional. Although there is a presumption that statutes are constitutional, facially discriminatory restrictions on interstate commerce are subject to the strictest scrutiny and are virtually per se

invalid, and the State must establish the requirements for a valid compensatory tax. *Fulton,* 516 U.S. at 332, 344; *Oregon Waste,* 511 U.S. at 99-101.

The Commissioner argues the dividends received deduction is a valid compensatory tax. The Commissioner argues the "intangibles tax" found unconstitutional in *Fulton* and the dividends received deduction in this case are not similar. We reject the Commissioner's arguments.

In *Fulton,* 516 U.S. at 328, the Supreme Court described North Carolina's "intangibles tax" on the fair market value of corporate stock owned by North Carolina residents:

> [A] corporation doing all of its business within the State would pay corporate income tax on 100% of its income, and the taxable percentage deduction allowed to resident owners of that corporation's stock under the intangibles tax would likewise be 100%. Stock in a corporation doing no business in North Carolina, on the other hand, would be taxable on 100% of its value. For the intermediate cases, holders of stock were able to look up the taxable percentage for a large number of corporations as determined and published annually by the North Carolina Secretary of Revenue (Secretary). In 1990, for example, the Secretary determined the appropriate taxable percentage of IBM stock to be 95%, meaning that IBM did 5% of its business in North Carolina, with its stock held by North Carolina residents being taxable on 95% of its value.

In *Fulton,* 516 U.S. at 334-36, North Carolina argued the "intangibles tax," with its taxable percentage deduction, compensated for the burden of the general corporate income tax paid by corporations doing business in North

Carolina. Because North Carolina had no general sovereign interest in taxing income earned out of state, however, North Carolina was required to identify some in-state activity or benefit to justify the compensatory levy. *Id.* at 334. The Supreme Court rejected North Carolina's argument that it could impose a compensatory tax on foreign corporations because they availed themselves of North Carolina's capital markets. *Id.* at 335-36. The Court said "'[p]ermitting discriminatory taxes on interstate commerce to compensate for charges purportedly included in general forms of intrastate taxation would allow a state to tax interstate commerce more heavily than in-state commerce anytime the entities involved in interstate commerce happened to use facilities supported by general tax funds.'" *Id.* at 335 (quoting *Oregon Waste,* 511 U.S. at 105 n.8). North Carolina failed to show the corporate income tax supported the maintenance of the capital market; it therefore failed to justify the use of the intangibles tax as replacement support for the market. *Fulton,* 516 U.S. 325 at 336.

The Supreme Court rejected North Carolina's claim that its intangibles tax was roughly approximate to, but did not exceed, the intrastate corporate income tax. *Fulton,* 516 U.S. at 336-38. The Court said the quantitative assessments necessary for the compensatory tax doctrine were difficult to apply to general forms of taxation:

> When a corporation doing business in a State pays its general corporate income tax, it pays for a wide range of things: construction and maintenance of a transportation network, institutions that educate the work force, local police and fire protection, and so on. The Secretary's justification for the intangibles tax, however, rests on

> only one of the many services funded by the corporate income tax, the maintenance of a capital market for the shares of both foreign and domestic corporations. To the extent that corporations do their business outside North Carolina, after all, they get little else from the State. Even, then, if we suppressed our suspicion that North Carolina actually funds its capital market through its blue sky fees, not its general corporate taxation, the relevant comparison for our analysis has to be between the size of the intangibles tax and that of the corporate income taxes component that purportedly funds the capital market.

Id. at 337-38.

The Supreme Court also rejected North Carolina's claim that its intangibles tax and its general corporate income tax fell on substantially equivalent events. *Fulton,* 516 U.S. at 338-44. The Court said it had found that equivalence only in the sales/use tax combination at issue in *Silas Mason,* but recent cases had demonstrated an extreme reluctance to recognize new compensatory categories. *Fulton,* 516 U.S. 325 at 338. The Court said the intangibles tax and general corporate income tax were different in a number of respects, including the parties ostensibly taxed, and those taxes did not satisfy the objective of the equivalent-event requirement to enable in-state and out-of-state businesses to compete on an equal footing. *Id.* at 340.

Here, N.D.C.C. § 57-38-01.3(1)(g) authorizes a dividends received deduction to a dividend recipient to the extent the dividend payor's income was subject to North Dakota corporate income tax, but does not grant a dividends received deduction to a dividend recipient if the dividend payor's income was not subject to North Dakota

corporate income tax. The Commissioner argues the intrastate tax burden for which the dividends received deduction attempts to compensate is the North Dakota corporate income tax paid by a North Dakota corporation that distributes the already taxed corporate profits as a dividend. The Commissioner argues the dividends received deduction compensates for the tax already paid on North Dakota income by the North Dakota corporation paying that dividend. The Commissioner argues "only one level of North Dakota income tax should be imposed on North Dakota income. The [dividends received deduction] insures that, in the end, there is only one level of North Dakota income tax on North Dakota income. Interstate commerce, i.e., the dividend from [an out-of-state corporation] to [taxpayers] bears the same burden . . . already borne by intrastate commerce, i.e., the dividend from [a North Dakota corporation] to [taxpayers]." The Commissioner offers the following comparative tax hypothetical, with a ten percent tax rate on North Dakota corporate income and on dividends:

	North Dakota Corporation	Out-of-State Corporation
Dividend Received by Taxpayers	$100	$100
North Dakota Corporate Income Tax on Profits out of which Dividend is Paid	$10	$0
Dividends Received Deduction	$100	$0
Taxable Dividend	$0	$100
North Dakota Corporate Income Tax on Receipt of Dividend	$0	$10

Total North Dakota Tax Paid By Dividend Payor Corporation and by Taxpayers	$10	$10

Although avoiding double taxation of North Dakota income is a permissible goal, the Commissioner has not identified any specific in-state activity or benefit received by the taxpayers to justify the compensatory levy on their dividends received from out-of-state corporations. The State of North Dakota does not have a general sovereign interest in taxing income earned out-of-state and must identify some specific in-state activity or benefit to justify a compensatory levy. *Fulton,* 516 U.S. at 334. The Commissioner has failed to establish such an in-state benefit to the taxpayers.

The Commissioner's comparative tax hypothetical ignores the corporate income tax that an out-of-state corporation's state might impose on the out-of-state corporation's profits, which effectively imposes a double layer of tax on the out-of-state income but not on the in-state income. The risk of multiple taxation may be considered in assessing a Commerce Clause claim, *see Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 444, 63 L. Ed. 2d 510, 100 S. Ct. 1223 (1980); 1 Hellerstein and Hellerstein, ¶ 4.08[1][a], and in considering whether a tax is discriminatory, the United States Supreme Court has applied the "internal consistency" doctrine. *Armco Inc. v. Hardesty,* 467 U.S. 638, 644, 81 L. Ed. 2d 540, 104 S. Ct. 2620 (1984). *See American Trucking Ass'ns, Inc. v. Scheiner,* 483 U.S. 266, 283, 97 L. Ed. 2d 226, 107 S. Ct. 2829 (1987); *Tyler Pipe Indust. Inc. v. Washington State Dep't of Rev.,* 483 U.S. 232, 241, 97 L. Ed. 2d 199, 107 S. Ct. 2810 (1987). *See generally* 1 Hellerstein and Hellerstein, ¶ 4.15[1]. The internal consistency doctrine requires

that the imposition of a tax identical to a challenged tax in every state would add no burden to interstate commerce that intrastate commerce did not also bear, and looks at the structure of the challenged tax to see whether its identical application by every state would place interstate commerce at a disadvantage against intrastate commerce. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185, 131 L. Ed. 2d 261, 115 S. Ct. 1331 (1995). The internal consistency test does not require other states to actually impose a similar tax to place a burden on interstate commerce; rather, a tax that exposes a taxpayer to a risk of multiple taxation is invalid under the Commerce Clause. *See Scheiner,* 483 U.S. 266 at 285; *Tyler Pipe,* 483 U.S. 232 at 241; *Armco,* 467 U.S. 638 at 644-45. *See also* 1 Hellerstein and Hellerstein, at ¶ 4.15[1][a].

Here, when the effect of the corporate income tax that an out-of-state corporation's state might impose on the out-of-state corporation's profits is considered, the dividends received deduction does not avoid double taxation for out-of-state corporate income and does not roughly approximate the tax on intrastate commerce under the Commissioner's comparative tax hypothetical. We conclude the dividends received deduction does not satisfy the first two elements of the compensatory tax doctrine, and we need not address whether the interstate and intrastate taxes are imposed on substantially equivalent events. *See Fulton,* 516 U.S. at 340 (stating general corporate income tax and intangibles tax are different in a number of obvious aspects, including the parties ostensibly taxed). We conclude the dividends received deduction is not a valid compensatory tax.

III

Relying on *Oregon Waste,* 511 U.S. at 100-01 and *New Energy Co. v. Limbach,* 486 U.S. 269, 278, 100 L. Ed. 2d 302, 108 S. Ct. 1803 (1988), the Commissioner nevertheless argues the dividends received deduction is valid because it serves a legitimate local purpose of preventing double taxation which cannot be served by reasonable nondiscriminatory alternatives.

However, *Oregon Waste* does not apply an alternative commerce clause test for compensatory tax cases. In *Oregon Waste,* 511 U.S. at 100-01 (quoting *Limbach,* 486 U.S. at 278), the Court said if a state regulation discriminates against interstate commerce, the regulation is analyzed under the "virtually *per se* rule of invalidity," and the regulation must be invalidated unless the State can "'show that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.'" The Court said justifications for discriminatory restrictions on commerce must pass the "strictest scrutiny", the State's burden of justification is so heavy that facial discrimination by itself may be a fatal defect, and the compensatory tax doctrine "is merely a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means." *Oregon Waste,* 511 U.S. at 100-02. Under *Oregon Waste,* the compensatory tax doctrine was the test applied for analyzing justification of a facially discriminatory tax. Moreover, although avoiding double taxation of North Dakota income is a legitimate legislative goal, "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." *Oregon Waste,* at 100. We have concluded the method employed by the State of North Dakota

impermissibly discriminates against interstate commerce. Taxpayers have asserted and the Commissioner does not dispute there are nondiscriminatory means to accomplish the goal of avoiding double taxation on North Dakota corporate income.

IV

We conclude the dividends received deduction is not a valid compensatory tax and impermissibly discriminates against interstate commerce; therefore, N.D.C.C. § 57-38-01.3(1)(g) violates the Commerce Clause of the United States Constitution and is invalid.[2] We affirm the district court judgment.

Carol Ronning Kapsner
Dale V. Sandstrom
William A. Neumann
Mary Muehlen Maring
Gerald W. VandeWalle, C.J.

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[2] Having declared subsection (g) unconstitutional has no effect on the remainder of the statute. *See* N.D.C.C. § 1-02-20. *See also Montana-Dakota Utils. Co. v. Johanneson*, 153 N.W.2d 414, 424-25 (N.D. 1967).

APPENDIX B

LEXSEE 85 CAL APP 4TH 875

CERIDIAN CORPORATION, Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.

No. A084298.

COURT OF APPEAL OF CALIFORNIA, FIRST APPELLATE DISTRICT, DIVISION THREE

85 Cal. App. 4th 875; 102 Cal. Rptr. 2d 611; 2000 Cal. App. LEXIS 974; 2000 Cal. Daily Op. Service 10156; 2000 Daily Journal DAR 13563

December 21, 2000, Decided

SUBSEQUENT HISTORY:

As Modified on Denial of Rehearing January 18, 2001, Reported at: 2001 Cal. App. LEXIS 27. No Change in Judgment.

PRIOR HISTORY: Superior Court of the City and County of San Francisco. Super. Ct. No. 983-377. Carlos Bea, Judge.

DISPOSITION: We hold that Revenue and Taxation Code section 24410 is an unconstitutional enactment in that it violates the commerce clause both by allowing a deduction for insurance subsidiary dividends only to corporations domiciled in California, and in limiting the amount of the deduction according to a formula based on the subsidiary's gross receipts, payroll and property within the state. The trial court's judgment invalidating the statute and awarding Ceridian the stipulated amount of tax refund is affirmed.

COUNSEL: Bill Lockyer, Attorney General, Randall P. Borcherding and Julian O. Standen, Deputy Attorneys General, for Defendant and Appellant.

Preston, Gate & Ellis, James P. Kleier and Julie A. Aguilar for Plaintiff and Respondent.

Morrison & Foerster, Thomas H. Steele, Amy L. Silverstein and Mariah A. Panza for Wells Fargo & Company as Amicus Curiae on behalf of Plaintiff and Respondent.

Wm. Gregory Turner for California Taxpayers' Association as Amicus Curiae on behalf of Plaintiff and Respondent.

JUDGES: Opinion by Parrilli, J., with McGuiness, P.J., and Walker, J., concurring.

OPINION BY: Parrilli

OPINION:

PARRILLI, J.

In this case we hold that Revenue and Taxation Code section 24410 violates the commerce clause of the United States Constitution.

The Franchise Tax Board of the State of California (Board) appeals from a judgment awarding a refund to Ceridian Corporation (Ceridian). The trial court ruled that the statute governing taxation of insurance company dividends paid to major corporate stockholders is unconstitutional. The Board claims this ruling was erroneous, and also contends that even if the statute is invalid, a tax refund is not the proper remedy. We agree with the trial court on both issues and affirm the judgment.

I. FACTS

Ceridian, formerly Control Data Corp. (Control Data), sought a refund of corporate franchise taxes imposed upon Control Data for the income years 1978 through 1982, and upon Commercial Credit Company (Commercial Credit) for the income years 1978 and 1979. Ceridian is the successor to all causes of action and rights asserted herein on behalf of Control Data and Commercial Credit. Ceridian is a Delaware corporation, with its commercial domicile in Minnesota. Commercial Credit is a Delaware corporation with its commercial domicile in Maryland. During the income years at issue, Commercial Credit was a wholly owned subsidiary of Control Data.

During the income years 1978 through 1982, Control Data was engaged in the business of manufacturing and selling computers, computer systems and peripheral equipment, and in providing computer-related services. Commercial Credit was engaged, through its subsidiaries, in the business of providing financial services and insurance to businesses and individual customers.

Control Data and Commercial Credit filed separate California Bank and Corporation Tax returns for themselves and their wholly owned groups for 1978 and 1979. Thus, each entity calculated its own business income and apportioned income to California based upon the averages of its California property, payroll and sales as a percentage of total property, payroll and sales. For the tax years 1980 through 1982, Control Data and Commercial Credit filed California corporate franchise tax returns on the combined report method. Under this method, the taxable business income for Control Data and Commercial Credit was combined, and then apportioned to California based upon

the averages of their combined California property, payroll and sales as a percentage of total combined property, payroll and sales.

In 1985, the Board recomputed the California tax liabilities of Control Data and Commercial Credit for the income years 1978 and 1979 on the basis that a combined report should have been filed, rather than separate returns. Additionally, the Board determined that business income included on these combined returns, as well as the combined returns filed for the 1980 through 1982 years, should have included approximately $78 million in dividends received from the insurance company subsidiaries. Ceridian paid the disputed amount and exhausted its administrative remedies.

On December 19, 1996, Ceridian filed a complaint for refund of taxes, alleging that taxation of Commercial Credit's insurance subsidiary dividends violated due process and the commerce clause of the federal Constitution. The case came before the trial court on stipulated facts. On May 7, 1998, the court issued its tentative decision, finding that Revenue and Taxation Code section 24410 is facially discriminatory and violates the commerce clause. The court awarded Ceridian a tax refund in the stipulated amount of $556,442. Judgment was entered accordingly (Code Civ. Proc., § 632; Cal. Rules of Court, rule 232), and the Board filed a timely notice of appeal.

II. DISCUSSION

A. *Constitutional Validity of Section 24410*

1. *The Revenue and Taxation Code*[1]

With certain exceptions, every corporation doing business in California pays an annual franchise tax measured by its net income. (§ 23151.) When that income is derived from or attributable to sources both within and outside the state, it is apportioned in accordance with the Uniform Division of Income for Tax Purposes Act (§ 25120 et seq.). (§§ 25101, 25121.) The Act's allocation formula is based on the proportion of a corporation's total property, payroll and sales which are located in the state. (§§ 25128-25136.) In computing its taxable income, a corporation may deduct "[d]ividends declared from income under franchise, alternative minimum, or income taxes." (§§ 24401, 24402.) The purpose of this dividend deduction is "to avoid double taxation *at the corporate level* of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation. [Citations.]" (*Safeway Stores, Inc. v. Franchise Tax Board* (1970) 3 Cal. 3d 745, 749-750 [91 Cal. Rptr. 616, 478 P.2d 48] italics in original (*Safeway Stores*).)

In lieu of the corporate franchise tax, insurance companies pay an annual tax based on the amount of gross premiums, less return premiums, received upon business done in this state. (§ 12221; Cal. Const., art. XIII, § 28.) The statute at issue in this case allows a deduction in computing taxable income (§ 24401) for "Dividends received

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[1] Unless otherwise indicated, all further statutory references are to the Revenue and Taxation Code.

by a corporation commercially domiciled in California, during the income year from an insurance company subject to tax imposed by [the "Insurance Taxation" part] of this division at the time of the payment of the dividends and at least 80 percent of each class of its stock then being owned by the corporation receiving the dividend." (§ 24410, subd. (a).) The deduction is "limited to that portion of the dividends received which are determined to be paid from income from California sources determined pursuant to subdivision (c)." (§ 24410, subd. (b).) The apportionment formula set out in subdivision (c) uses the average of three factors – gross receipts, payroll, and property – to determine an insurance company dividend payor's gross income from California sources, which is then used to determine the amount of dividends paid from California sources.[2] The parties herein stipulated that for

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[2] In pertinent part, section 24410 establishes a deduction for: "(a) Dividends received by a corporation commercially domiciled in California, during the income year from an insurance company subject to tax imposed by Part 7 (commencing with Section 12001) of this division at the time of the payment of the dividends and at least 80 percent of each class of its stock then being owned by the corporation receiving the dividend. [¶] (b) The deduction under this section shall be limited to that portion of the dividends received which are determined to be paid from income from California sources determined pursuant to subdivision (c). [¶] (c) Dividends paid from California sources shall be determined by multiplying the amount of the dividends by an apportionment factor equal to the ratio of gross income from California sources to all gross income of the company. Gross income from California sources equals total gross income less dividends from other insurance companies multiplied by the average of the following three factors: [¶] (1) A gross receipts factor, the denominator of which shall include all receipts, other than dividends from another insurance company, regardless of the nature or source from which derived. The numerator of which shall include all gross receipts, other than dividends from another insurance company, derived from or attributable to this state.

(Continued on following page)

purposes of subdivision (b), "for each of the years at issue, the average percentage of the payroll, property and gross receipts in California of each insurance company paying dividends" to Ceridian is 1.77 percent.

2. *The Commerce Clause*

The Constitution gives Congress the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) "Though phrased as a grant of regulatory power to Congress, the [Commerce] Clause has long been understood to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce. [Citations.]" (*Oregon Waste Systems, Inc. v. Department of Environmental Quality of the State of Ore.* (1994) 511 U.S. 93, 98 [114 S. Ct. 1345, 1349, 128 L. Ed. 2d 13] (*Oregon Waste*).) "This 'negative' aspect of the Commerce Clause prohibits

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With respect to premiums, only receipts which were subject to tax under Part 7 (commencing with Section 12001) of this division, shall be included in the numerator, and with respect to income from intangibles they shall be attributable to the commercial domicile of the insurance company. [¶] (2) A payroll factor determined under the provisions of the Uniform Division of Income for Tax Purposes Act, Chapter 17, Article 2 of this part. [¶] (3) A property factor, determined under the provisions of the Uniform Division of Income for Tax Purposes Act provided for in Article 2 (commencing with Section 25120) of Chapter 17 of this part, provided that for the purposes of this paragraph the property factor shall include all intangible investment property, which intangible property shall be allocated to the commercial domicile of that insurance company. [¶] (4) Plus the portion of the dividends received from another insurance company determined to be paid from California source income pursuant to the formula set forth in paragraphs (1) through (3) based upon the receipts, payroll and property of that other insurance company."

economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors. [Citations.] Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down [citations], unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism [citation]." (*New Energy Co. of Indiana v. Limbach* (1988) 486 U.S. 269, 273-274 [108 S. Ct. 1803, 1807-1808, 100 L. Ed. 2d 302].) Supreme Court cases "leave open the possibility that a State may validate a statute that discriminates against interstate commerce by showing that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. [Citations.] This is perhaps just another way of saying that what may appear to be a 'discriminatory' provision in the constitutionally prohibited sense – that is, a protectionist enactment – may on closer analysis not be so. However it be put, the standards for such justification are high. [Citations.]" (*Id.* at pp. 278-279 [108 S. Ct. at p. 1810]; see also *Hughes v. Oklahoma* (1979) 441 U.S. 322, 337 [99 S. Ct. 1727, 1737, 60 L. Ed. 2d 250] [facial discrimination invokes "strictest scrutiny."]

3. *Discriminatory Taxation*

Under the commerce clause, "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." (*Armco Inc. v. Hardesty* (1984) 467 U.S. 638, 642 [104 S. Ct. 2620, 2622, 81 L. Ed. 2d 540].)

As it did below, the Board essentially concedes that subdivision (a) of section 24410, which allows only corporations "commercially domiciled" in California to deduct certain insurance company dividends from their taxable income, violates the commerce clause.[3] We agree that subdivision (a) violates the commerce clause because it limits the pertinent deduction to those corporations "commercially domiciled" in California. Thus, the only disputed issue in this case is whether subdivision (b), which limits the deduction to dividends "paid from income from California sources" also violates the commerce clause. We conclude that it does.

The trial court found section 24410, subdivision (b) "patently discriminatory," because "[o]n its face, this taxing scheme discriminates against the owner of insurance companies which do business in California, but retain their property and payroll in other states, on no basis other than their refusal to relocate their property and payroll to California." The Board contends, on the contrary, that subdivision (b) is a constitutionally valid means of avoiding double taxation, analogous to that provided for noninsurance subsidiaries by section 24402 (*ante,* p. 881). The Board claims subdivision (b) does not discriminate against or burden interstate commerce, but levels the playing field between corporate taxpayers receiving

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[3] However, the Board is constitutionally compelled to enforce the provision until it is judicially invalidated: "An administrative agency, . . . has no power: [¶] (a) To declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional; [¶] (b) To declare a statute unconstitutional. . . . " (Cal. Const., art. III, § 3.5, subds.(a) & (b).)

dividends from insurance companies doing business in California, which are subject to the gross premiums tax, and those receiving dividends from insurance companies doing business elsewhere, which are not. Were it not for subdivision (b), the Board argues, California would tax the former's income twice, and the latter's only once.

Both Ceridian and amici curiae Wells Fargo and California Taxpayers' Association (hereafter, amici) vigorously assert that section 24410, subdivision (b) does *not* prevent double taxation. However, the parties' debate about whether subdivision (b) does or does not prevent double taxation misses the mark. The issue is not whether subdivision (b) serves some legitimate purpose, but whether it survives a commerce clause challenge. Significantly, the Board's authorities do not stand for the proposition that a commerce clause challenge would be overcome even if subdivision (b) prevented double taxation.

For example, the case of *United States v. Woodmansee* (N.D.Cal. 1975) 388 F. Supp. 36 (revd. in *United States v. Woodmansee* (9th Cir. 1978) 578 F.2d 1302), cited for the proposition that "the protection of competition has been recognized as a legitimate goal of tax laws intended to avoid double taxation," concerns a *federal* statute and thus does not present a negative commerce clause problem.

Moreover, a tax may violate the commerce clause even if it has no discriminatory goal or intent, if it is facially discriminatory, or has the *effect* of unduly burdening interstate commerce. (*Amerada Hess Corp. v. N.J. Taxation Div.* (1989) 490 U.S. 66, 75 [109 S. Ct. 1617, 1622-1623, 104 L. Ed. 2d 58].) "Absent a compelling justification . . . a State may not advance its legitimate goals by means that facially discriminate against [interstate] commerce.

[Citations.]" (*Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance* (1992) 505 U.S. 71, 81, [112 S. Ct. 2365, 2371, 120 L. Ed. 2d 59].)

The Board asserts that section 24402 (the general dividend deduction statute) "has been recognized as a valid means of avoiding double taxation." Accepting arguendo the Board's characterization of section 24402 as the "counterpart" of section 24410 (see *ante*, p. 620, fn. 6), none of the cases cited by the Board concerned a commerce clause challenge, nor did they hold that section 24402 is a constitutionally valid means of avoiding double taxation. (See *Safeway Stores, supra,* 3 Cal. 3d at pp. 749-750; *Great Western Financial Corp. v. Franchise Tax Bd.* (1971) 4 Cal. 3d 1, 6 [92 Cal. Rptr. 489, 479 P.2d 993]; *Max Factor & Co. v. Franchise Tax Bd.* (1973) 35 Cal. App. 3d 7, 11 [110 Cal. Rptr. 536].)

The Board relies primarily on a footnote in a 65-year-old Supreme Court case. In *Colgate v. Harvey* (1935) 296 U.S. 404 [56 S. Ct. 252, 80 L. Ed. 299, 102 A.L.R. 54] (*Colgate*), the court looked at a Vermont statute that "impose[d] a tax upon dividends earned outside the State of Vermont, while exempting from the tax dividends earned within the state," and also "discriminate[d] in favor of money loaned within the state as against money loaned outside the state [.]" (*Id.* at pp. 418-419 [56 S. Ct. at p. 252].) The court considered challenges to the statute under both the equal protection and privileges and immunities clauses of the Fourteenth Amendment. (*Id.* at p. 419 [56 S. Ct. at p. 254].) In a footnote, the court remarked, "The further point is made that the discrimination in respect of dividends and interest upon loans is a regulation of interstate commerce and therefore void under the commerce clause of the federal Constitution. But we

mention this latter claim only to reject it as without merit, since clearly a tax upon income is not an interference with interstate commerce simply because the income is derived from a source within another state; and moreover, if there be any tendency to interfere with such commerce it is purely collateral and incidental. [Citations.]" (*Ibid.*, fn. 2. [56 S. Ct. at p. 254].) The court went on to uphold the dividends provision, but invalidate the interest provision (*id.* at p. 436 [56 S. Ct. at pp. 261-262]); it later overruled *Colgate* insofar as it had found therein a violation of the privileges and immunities clause (*Madden v. Kentucky* (1940) 309 U.S. 83, 93 [60 S. Ct. 406, 410-411, 84 L. Ed. 590, 125 A.L.R. 1383]).

Later still, a federal appeals court rejected the appellants' reliance on footnote 2 of *Colgate, supra,* 296 U.S. at page 419. The appeals court noted that Supreme Court decisions in the half-century after *Colgate* was decided confirmed the district court's finding that *Colgate*'s "collateral" or "direct-indirect" test had been replaced by "the more realistic inquiry of whether a law 'substantially affects' interstate commerce." (*Dominion Nat. Bank v. Olsen* (6th Cir. 1985) 771 F.2d 108, 111.) A concurring judge went further, asserting that the *Colgate* commerce clause analysis, emphasizing whether a state directly taxed interstate commerce rather than whether it created a competitive advantage for local business, "has been overruled *sub silentio*" and "no longer is good law." (*Id.* at pp. 118, 119, conc. opn. of Contie, J.).)

4. *Subdivision (b) violates the Commerce Clause*

Under modern Supreme Court jurisprudence, a tax scheme may survive a commerce clause attack only when

it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, *does not discriminate against interstate commerce,* and is fairly related to the services provided by the State." (*Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, 279 [97 S. Ct. 1076, 1079, 51 L. Ed. 2d 326], italics added.) "If a restriction on commerce is discriminatory, it is virtually *per se* invalid. [Citations.]" (*Oregon Waste, supra,* 511 U.S. at p. 99 [114 S. Ct. at p. 1350].) Nevertheless, a facially discriminatory tax scheme "may be saved from constitutional infirmity if it is a valid 'compensatory tax' designed simply to make interstate commerce bear a burden already borne by intrastate commerce." (*Associated Industries of Mo. v. Lohman* (1994) 511 U.S. 641, 647 [114 S. Ct. 1815, 1821, 128 L. Ed. 2d 639].)[4] "To justify a charge on interstate commerce as a compensatory tax, a State must, as a threshold matter, 'identify the intrastate tax burden for which the state is attempting to compensate.' [Citation.] Once that burden has been identified, the tax on interstate commerce must be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce. [Citation.] Finally, the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other. [Citation.]" (*Oregon Waste, supra,* 511 U.S. at p. 103 [114 S. Ct. at p.

[4] The Board thus misspeaks when it cites *United States v. Salerno* (1987) 481 U.S. 739, 745 [107 S. Ct. 2095, 2100, 95 L. Ed. 2d 697] for the proposition that a "facially discriminatory law" is one which cannot under any circumstances be applied constitutionally. It is, of course, a facially *unconstitutional* law which, by definition, cannot be constitutionally applied.

1352], internal brackets and ellipses omitted; see also *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, 332 [116 S. Ct. 848, 854, 133 L. Ed. 2d 796 (*Fulton.*)

Significantly, the Board is not contending that the tax scheme under consideration here can be justified as a "compensatory tax." Indeed, the Board has gone so far as to disclaim this position in its reply brief, stating that "*Fulton* is distinguishable because this appeal does not involve a tax on interstate commerce intended to compensate for the burden on intrastate commerce imposed by a different tax."

(see fn. 5.) This concession is well taken, since the tax scheme at issue does not meet the three requirements for a "compensatory tax."[5]

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[5] First, to justify a tax scheme as "compensatory," *the state* has the responsibility to identify the intrastate tax burden for which the state is attempting to compensate. (*Fulton, supra,* 516 U.S. at p. 334 [116 S. Ct. at p. 855].) Here, the state has not only failed to identify such a tax burden, it has explicitly disclaimed that the tax scheme at issue in this case was designed "to compensate for the burden on intrastate commerce imposed by a different tax."

Second, to invoke the "compensatory tax defense" the state must show that the tax on interstate commerce roughly approximates, but does not exceed, the amount of the tax on intrastate commerce. (*Fulton, supra,* 516 U.S. at pp. 334, 335 [116 S. Ct. at pp. 855, 855-856].) The Board produced no proof whatsoever on this subject at trial or on appeal.

Finally, the state must show that the "compensating taxes" fall on substantially equivalent events, meaning they must be sufficiently similar in substance to serve as mutually exclusive "proxies" for each other. (*Fulton, supra,* 516 U.S. at pp. 332, 338 [116 S. Ct. at pp. 854, 857].) The state does contend that the California insurance premium tax scheme is a "proxy" for the California franchise tax. But even if this were true, the insurance premium tax scheme cannot qualify as a

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Instead, the Board's contention is that section 24410, subdivision (b) "does not discriminate against interstate commerce" and thus it is not even necessary to reach the "compensatory tax defense" issue. In other words, the Board is contending that the statute is not discriminatory because it avoids double taxation. This is a non-sequitur. If subdivision (b) discriminates against interstate commerce, as we conclude it does, then it is virtually per se invalid *unless* it is a component of a valid "compensatory tax." The fact that the tax scheme may serve some other laudatory purpose does not save it from a commerce clause challenge.

Both Ceridian and amici rely heavily on *Fulton, supra,* 516 U.S. 325. In that case, the United States Supreme Court considered a North Carolina statute that imposed a one quarter of one percent "intangibles" tax on the fair market value of corporate stock owned by North Carolina residents. However, North Carolina residents were allowed to calculate their tax liability under this provision by "taking a taxable percentage deduction equal to the fraction of the issuing corporation's income subject to tax in North Carolina." (*Id.* at p. 327-328 [116 S. Ct. at p. 852]) This figure was determined by looking at the proportion of the issuing corporation's sales, payroll and property located in North Carolina. The net effect of the tax scheme was that a corporation doing all of its business within North Carolina would pay corporate income taxes on 100% of its income, meaning that a North Carolina

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"compensatory" tax since the state has utterly failed to establish the other elements of the "compensatory tax defense" to a facially discriminatory tax statute.

resident who owned stock in that company would avoid the "intangibles" tax entirely. At the other extreme, a North Carolina resident who owned shares in a corporation that conducted *no* business within North Carolina would have to pay the .25% tax on the full (100%) market value of the stock. Similarly, the share values of corporations that conducted some (but not all) of their business within North Carolina would be subject to a sliding scale deduction. (*Id.* at p. 328 [116 S. Ct. at p. 852].)

The *Fulton* Court determined that this tax scheme facially discriminated against interstate commerce. The court reasoned: "A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce."[6] (*Fulton, supra,* 516 U.S. at p. 333 [116 S. Ct. at p. 855].) Similarly, a statutory scheme, such as the one before us, that disallows a deduction based on the amount of *property and employees* that the dividend – declaring insurer has in another state, favors domestic corporations over their foreign competitors in raising capital among California corporations, and tends, at least, to discourage domestic corporations from plying their trade in interstate commerce, from purchasing property or hiring employees in other states, and from purchasing subsidiary insurance

[6] The Supreme Court also went on to hold that the North Carolina intangibles tax scheme was not a valid "compensatory" tax. However, since the Board has disclaimed a similar justification for the tax scheme in this case, we do not address that portion of *Fulton* in detail.

corporations that do so. Thus, section 24410, subdivision (b) is unquestionably discriminatory on its face.

In sum, the tax and deduction scheme at issue fits within *Fulton's* analytical framework. Just as in *Fulton,* here the state imposes a tax based on value derived from ownership of a corporation. Just as North Carolina reduced its intangibles tax in direct proportion to the amount of business the owned corporation did within the state's borders, so too California reduces the dividend tax to the extent such dividends are "paid from income from California sources," (§ 24410, subd. (b)), which is calculated based on the proportionate amount of property, payroll and gross receipts the owned corporation has within California. Fulton prohibits such discriminatory treatment.

Our analysis leads us to the same conclusion the trial court reached: both subdivision (a) and subdivision (b) of section 24410 place an unjustifiable burden on interstate commerce and are therefore unconstitutional.[7]

B. *Remedies*

1. *Ceridian: Refund or Retroactive Assessment*

"If a State places a taxpayer under duress promptly to pay a tax when due and relegates him to a postpayment refund action in which he can challenge the tax's legality, the Due Process Clause of the Fourteenth Amendment

[7] Since it is not at issue here, we express no opinion as to the constitutionality of section 24402.

obligates the State to provide meaningful backward-looking relief to rectify any unconstitutional deprivation." (*McKesson Corp. v. Florida Alcohol & Tobacco Div.* (1990) 496 U.S. 18, 31 [110 S. Ct. 2238, 2247, 110 L. Ed. 2d 17] (*McKesson*).) The *McKesson* court specified three ways in which a state may provide the requisite "clear and certain remedy" (*id.* at p. 40 [110 S. Ct. at p. 2252]) for its erroneous or unlawful tax collection. Under these guidelines, the Board in this case may 1) refund to Ceridian the difference between the tax it paid and the tax it would have been assessed were it allowed the same deductions its competitors actually received, 2) assess and collect back taxes from Ceridian's competitors who benefited from the deductions during the contested tax period, or 3) fashion a combination of partial refund to Ceridian and partial retroactive assessment of tax increases on its favored competitors. (*Id.* at pp. 40-41 [110 S. Ct. at pp. 2252-2253].)

A retroactive assessment remedy is codified in section 19393, which provides, in relevant part, that for franchise tax purposes, if any deduction provided for by the Bank and Corporation Tax Law (§ 23001 et seq.) "is finally adjudged discriminatory against a national banking association contrary to Section 548 of Title 12 of the United States Code,[8] or is for any reason finally adjudged invalid, or discriminatory under the California Constitution, or the laws or the Constitution of the United States,

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[8] "For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located." (12 U.S.C. § 548.)

the tax of the favored taxpayer shall be recomputed by the Franchise Tax Board for the taxable year in question, . . . by disallowing the deduction. . . ." The trial court was persuaded that section 19393 "has to do with banks, not insurance companies nor holding companies which hold insurance companies," and ordered a refund instead.

On appeal, the Board challenges the court's interpretation of the scope of section 19393, arguing it is not limited to banks. We need not resolve this issue. That is because the parties agree that retroactive tax collection in this case is impossible, since the tax years in question are 1978-1982, and the statute of limitations for assessment or collection of a tax deficiency is four years (§ 19057). Thus, even if section 19393 is broad enough to cover Ceridian, it cannot provide the constitutionally required relief in this case. The Board seems to recognize as much when it reminds us again that it cannot refuse to enforce the provision unless and until it has been adjudged unconstitutional (Cal. Const., art. III, § 3.5). We therefore hold that section 19393 violates a taxpayer's right to due process, where, as here, the retroactive assessment it provides cannot lawfully be collected. Accordingly, the trial court did not err by awarding Ceridian the stipulated refund.[9]

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[9] The Board maintains that even if Ceridian cannot be denied a refund, section 19393 should be applied to taxpayers that benefited from the deduction and as to whom readjustment of tax liability is not time-barred. On the other hand, not surprisingly, amici repeatedly refer to refunds due to "Ceridian and *similarly situated* taxpayers." This is not a class action suit; only Ceridian's refund claim is before us. Accordingly, we express no general opinion regarding the appropriate remedy in other cases, nor do we address the breadth of section 19393.

2. *Section 24410: Reform or Invalidation*

"[A] court may reform – i.e., 'rewrite' – a statute in order to preserve it against invalidation under the Constitution, when we can say with confidence that (i) it is possible to reform the statute in a manner that closely effectuates policy judgments clearly articulated by the enacting body, and (ii) the enacting body would have preferred the reformed construction to invalidation of the statute." (*Kopp v. Fair Pol. Practices Com.* (1995) 11 Cal.4th 607, 660-61 [47 Cal. Rptr. 2d 108, 905 P.2d 1248] (*Kopp*).) The Board suggests reformation of section 24410 might be appropriate if *only* subdivision (a), granting a dividend deduction solely to California corporations, were invalid. However, subdivision (a), which plainly applies only to corporations "commercially domiciled" in California, is clear and unambiguous on its face. Thus, we may not divine the legislative intent from other sources. (*Pacific Gas & Electric Co. v. Public Utilities Corm.* (2000) 85 Cal. App. 4th 86, 91-92, 95-96 [102 Cal. Rptr. 2d 20].) It follows that section 24410, subdivision (a) is not subject to reformation. (85 Cal. App. 4th at pp. 91-92, 95-96.) Moreover, even if we could reform subdivision (a) it would not save the statutory scheme. The deductions thus more broadly allowed would still be calculated in accordance with a formula that we have determined violates the commerce clause. As the Board recognizes, attempting to rewrite subdivision (b) would involve us in precisely the type of judicial policymaking and encroachment on the legislative function in violation of the separation of powers doctrine, against which the *Kopp* court warned. (*Kopp, supra,* 11 Cal. 4th at p. 661.) Thus, reformation is not possible in this case.

III. CONCLUSION AND DISPOSITION

We hold that Revenue and Taxation Code section 24410 is an unconstitutional enactment in that it violates the commerce clause both by allowing a deduction for insurance subsidiary dividends only to corporations domiciled in California, and in limiting the amount of the deduction according to a formula based on the subsidiary's gross receipts, payroll and property within the state. The trial court's judgment invalidating the statute and awarding Ceridian the stipulated amount of tax refund is affirmed.

McGUINESS, P.J., and WALKER, J., concur.

A petition for a rehearing was denied January 18, 2001, and the opinion was modified to read as printed above.
